TARP Congressional Oversight Panel Field Hearing

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Written Testimony of Chris Burnett

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Good morning. I am Chris Burnett, Chief Executive Officer of Cornerstone Bank headquartered here in Atlanta. Cornerstone is one of Georgia's 25 largest community banks with assets of $550 million. With one-third of our loans in housing, one-third in small business financing and one-third in commercial real estate loans, we have a balanced portfolio and a balanced perspective on the problems facing our economy today.

You have asked me to testify today about three things; commercial real estate lending, commercial real estate problems and the effects of TARP on the commercial real estate marketplace.

I'll first describe what composes Real Estate Lending, including commercial real estate, for Georgia's banks and briefly describe the current state of each of those segments. Then I'll discuss particular problems in the appropriate segments. I'll finish with my views of the effects of TARP investments on our marketplace.

Bank Real Estate Lending

There are five components of bank real estate lending: 1) acquisition development and construction, 2) 1-4 family residential, 3) multifamily residential real estate, 4) farmland and 5) commercial real estate. Each bank reports quarterly to FDIC how much of their portfolio is in each component, and this is available for the public to view.

In general, lending to the **Acquisition Development and Construction lending**, sector is minimal at this time. High foreclosures, high unemployment, low in-migration and the need to steeply reduce available inventory of homes means that loans for new developments and housing would represent significant additional risk for both borrowers and lenders.

Closely related to this is the **1-4 Family Residential** sector, which was similarly affected by the downturn and the evaporation of the mortgage market.

The third important category is **Multifamily lending.** This is primarily lending for apartments. This is an area of stress in the marketplace, especially in the more mature multifamily communities and buildings.

A fourth category is **Farmland**, and metro-Atlanta bankers are simply not involved in that financing.

A fifth category is **Commercial and Industrial lending**, which at our bank included loans to owner-occupied buildings as well as retail shopping centers and hotel lending.

Right now, most owner-occupied properties are holding their values relatively well compared to other property types. At my bank, we do not have any past due loans of this type at this time, so this is the sector in which we're seeing the least stress.

Outside of loans to borrowers heavily dependent on the residential real-estate industry, here's why these loans are holding up better than others. In general, businesses that own their own buildings as well as rent out other portions of those facilities have two things going for them. First, they generally tend to be more financially stable and have better cash reserves. Second, because they have other tenants, they are more likely to continue to have some monthly cash flow that helps them cover the debt service for their real estate loans.

However, reasonable concern is warranted, especially related to real estate loans to businesses associated directly with the residential construction sector, as well as those to owners and developers of retail centers.

I'll describe the more specific problems and concerns with each of these areas below.

Commercial Real Estate Problems

Residential AD&C Problems

The residential Acquisition Development and Construction segment has been the hardest hit in Georgia. This sector makes up the bulk of commercial real estate related lending for Georgia banks.

You simply can't talk about commercial real estate in Georgia without a discussion of residential development real estate. This has been the area of most distress, primarily as a result of the devastating and rapid real-estate market downturn.

Construction and land development loans were the first to be hit by the economic downturn. When the mortgage market seized up, the developers could not find buyers for their homes causing many of those developers to fail leaving hundreds of projects in suspension. The effect on their lenders was just as devastating. In Georgia, we have already seen 30 community banks fail, all of which had heavy concentrations in construction and land development lending. Those banks closed were all community banks, which shouldn't be a surprise as we have more community banks in Georgia than any other state in the Southeast.

The second component, one-four family residential, was similarly affected by the downturn and the evaporation of the mortgage market. The completed new home inventory the lenders ended up with has been less affected than partially completed homes. Atlanta has been fortunate in that we did not experience some of the huge home price increases some markets experienced. The fact that we have been known for being an affordable housing market is now paying off. That inventory of new construction, foreclosed homes is coming down.

At this point, the disastrous effects of the economy and credit crisis on these sectors are all too apparent and have already manifested themselves on our banks in the form of rising delinquencies, defaults and foreclosures on these undeveloped, partially built or even completed but unsold homes. We're now well into the cleanup phase of dealing with these problems, but even FDIC is predicting more failures as the residential real estate construction market is still troubled.

Multifamily Problems

The effects of the residential real estate collapse are also being felt in multifamily portfolios. For example, Georgia has lost about 300,000 jobs during this recession. A large percentage of those jobs are directly related to the construction industry. This massive loss of jobs associated with one sector has caused people to leave the region to seek employment elsewhere, driving up vacancies. This is especially apparent in multifamily properties that are older and on the lower end of the rent scale.

With the high numbers of foreclosures in Georgia, we expected that many of those families would move into vacant multifamily units. However, what has happened is that investors have been buying foreclosed homes at steep discounts and have been moving those homes into the rental market. We understand that in many cases, the cost to buy foreclosed single family homes is below what it would cost a developer to build a new multifamily rental unit. So, families forced to vacate their homes due to foreclosure or job loss are renting these single-family properties in greater numbers rather than predicted leaving multifamily units at the lower price point with higher vacancy rates.

This has a secondary effect directly on the value of single family homes in the area. Higher numbers of single family homes that are rental properties serve to lower property values in an area.

On the positive side of the multifamily equation is that long-term demographics appear to be in our favor. In three-to-four years, we feel like demand will be high for multifamily units. One example of why is that this year's freshman college class is expected to be the largest in history. Within the next three to four years, these young adults will move into the market for housing and most expect that will be in multifamily housing.

Commercial and Industrial (C&I) Problems

As I noted earlier, owner occupied facilities closely associated with the residential construction sector are the most stressed – businesses such as engineering firms, architects, industrial and interior design firms, real-estate attorneys and others.

With fewer homes being built, bought and sold, these businesses have held on as long as they can. These are the primary C&I defaults and losses for Georgia Banks. For example, our one C&I loan foreclosure was to a furniture business that simply could not keep the doors open any longer.

Perhaps the greatest area of concern in the C&I portfolio is for loans to retail shopping developments. Stress on these loans is directly related to the depth and length of the recession, high unemployment and a tightening of consumer purchasing.

As consumers have less money to spend as well as less willingness to spend the money they have, consumer-dependent businesses in these properties are more at risk. The longer we have high unemployment, lower than average consumer confidence and continued economic weakness, the more stress we'll see on these portfolios.

Borrowers with loans for these developments are more at risk for several reasons. First, they are dependent on the tenants being in business and paying their rents. Second, they have less reserves or net worth in the first place to weather downturns in their business. Faced with rising vacancies, declining rents and less demand from new tenants, these loans are the most at risk.

A second factor adding stress to both the owner-occupied and retail property portfolios is that those borrowers that are able to continue making payments are being challenged by declining property values and requests for significant rent concessions from tenants. The larger banks, insurance companies and pension funds that lend to much larger commercial projects than a bank our size would do are reporting similar stresses. Vacancy rates for these projects in metro-Atlanta are over 20 percent, a rate that is simply not sustainable with the level of debt most owners have incurred to bring their projects online.

Many of the borrowers are forced to make such rent reductions because having some rental income from tenants is simply better than having no rental income from tenants forced to go out of business because they can't pay the rent.

Banks are then confronted with a dilemma. They must either foreclose on the properties or restructure the mortgages, allowing them to convert to interest-only payment terms at lower interest rates. These loans then become known as “Troubled Debt Restructures,” meaning that they must be classified as “Substandard” assets.
A TDR triggers the need for a new property appraisal on the loan. In the current economy and marketplace, it is likely that appraisal will show a decline in property value, sometimes a very significant decline. This is preferable to an outright default and potential foreclosure, but there are downside effects on a bank's capital as well as the overall market. Here is a simple example of the capital effect that has on the bank.

In this example, the loan is based on an original appraisal of $10 million. If the new appraisal comes back at $9 million, the borrower has to pay down the loan or produce additional collateral. Otherwise the bank has to allocate the $1 million difference directly from our actual capital to our loan loss reserve. That's capital that we essentially can't recover from our reserves, even if the property value increases over time. The federal banking regulators announced new guidance on this in late October that was intended to help this exact situation. It is simply too early to tell if this guidance will produce positive results.

A secondary effect on the marketplace of significantly reduced rents is that it reduces the investment value of the property. Potential purchasers of that property base the investment value on rental income, or monthly cash flow. As that cash flow, and in-turn, value declines, those investors are demanding more return on their investment because of the higher risk. This makes the properties harder to market and sell to potential investors.

The long and deep recession has also taken a toll on loans to hotel developers and other businesses related to travel, hospitality and tourism.

For example, we have one loan on a hotel property near a major trade facility. This borrower reports that occupancy is running between 60-70% of its average during better economic times. This is directly related to reduced traffic from vendors and buyers attending various market events at the facility. And with less traffic at this facility, business is significantly off for local hotels, restaurants, catering and other service businesses that are reliant on a brisk business from the facility's merchants and customers.

Effects of TARP, Availability of Capital for Banks and Credit Availability

You asked me to discuss the effects of TARP on the commercial real estate market. I will do that in the context that the other significant factor affecting banks' ability to lend more is the availability of capital.

Twenty-six of the 306 Georgia-based banks have received Capital Purchase Program investments, totaling about $6.2 billion. It appears that has been a good investment, to date. Those institutions have paid the U.S. Government $239.7 million in dividends through mid-November as a return on its investment.

My bank is not among those institutions. The application process was perhaps the most frustrating regulatory experience in my 30 years in this business. Our bank applied in 2008 as soon as the program was announced. We were finally told to withdraw our application in October, 2009, almost a year after the program began. Early in the process, we had new capital lined up to invest alongside TARP, but after ten months of waiting for an answer, those capital sources had dried up.

The measure of TARP's effectiveness can basically be boiled down in two ways, in my opinion.

If the intent was to help banks clean up their balance sheets and rid themselves of troubled assets, it has been effective to a degree, here in Georgia. With the capital protection provided by TARP, those banks that received investments have been able to rid their books of distressed loans at valuations that are extremely low.

However, if the intent was to stimulate more lending, the jury is still out on its effectiveness... I am sure this has been helpful to those recipients, but there are other factors affecting the difficulty Cornerstone and other banks are having in extending more credit to businesses.

Business loan demand is down, and bank capital to support lending remains under extreme pressure. Also, sources of new capital are limited, sitting on the sidelines or looking elsewhere to invest.

Business loan demand and prudent caution

As I mentioned earlier, consumer spending remains muted and business loan demand is off. With more people saving more to pay off debt, companies have put off expansions or additions to inventories.

Also, banks are carefully balancing the need to lend more and avoid making more loans that might not be paid back because of the economy. In a recent national survey of lenders, more than 70 percent cited the poor economy as the number-one reason for conservative underwriting.

In Georgia, that shows up primarily in unemployment, which stands above 10 percent. Other factors are that business bankruptcies and loan delinquencies also continue to rise.

For example, through September there were 23,245 Chapter 7 bankruptcy filings in North Georgia. As of November, that number was 12.5 percent higher than full-year 2008 figures and 56 percent higher than the similar nine-month reporting period in 2008, according to data released by the U.S. Bankruptcy Court, Northern District of Georgia. I have not seen a recent update of this data.

So, the ongoing challenge in this environment for both a borrower and a bank is to be as certain as possible that a person or business can repay a loan, and that just takes a lot of I-dotting and T-crossing in this economy.

It may not seem like it sometimes, especially if you are a borrower, but the reality is a loan decision starts from the point of view that the bank wants to ensure that a borrower isn't taking on more risk than his or her family or business can reasonably support. That's protection for the borrower and good underwriting for the bank.

New Capital Scarce

So, there is a desire out there for banks to raise and deploy more capital to support new loans. That remains extremely difficult in this environment.

In relation to TARP, investors with available capital generally have taken a hands-off approach to most banks that did not receive investments or that were told to withdraw their applications. In our case, we had investors who voiced their sincere interest in matching any TARP funding we would have received. However, due to the delay in considering our application, their interest evaporated.

A second factor limiting new investment capital is the FDIC's approach to resolving failed banks. Because of the FDIC's trend toward entering loss-share agreements with acquirers of failed banks and in being more willing to grant shelf charters, non-bank investors have told me personally they'd rather sit back and be opportunistic about investing after a bank fails through those processes, rather than taking more risk by investing now.

A third factor inhibiting new capital investment is the uncertainty that comes from the current regulatory and political environment. As the Administration, Congress and regulators propose, debate and state their views on a wide variety of regulatory reform ideas, investors remain extremely cautious about investing in the banking sector. They are seriously concerned about the risk involved with investing before any of these reforms are finalized. The severe tone and unprecedented scope many of these proposals would have on potential returns for these investors is keeping them firmly on the sidelines and looking to invest their capital in other businesses.

Other Capital Constraints

Alongside the broad economic and policy constraints affecting credit availability and new capital, many of our state's banks simply are struggling to maintain adequate regulatory capital levels because of ongoing and rising numbers of troubled loans that are a direct result of the poor economy.

Regulators rightly require banks to maintain strong capital levels to cushion the blow of losses from bad loans. However, to keep those capital levels high, banks often can’t deploy that capital to provide funding for additional credit to small business and other borrowers as they must use that capital to account for current and projected future loan losses.

And, unfortunately, the economy has also led to an estimated one-third of Georgia banks being subject to regulatory enforcement orders.

In addition, these regulatory orders also have the result of restricting lending in other ways, too. It seems the rule, rather than the exception in these orders, for regulators to require higher minimum levels of tier-1 and total risk-based capital than the standard definitions used for banks that are considered well capitalized.

Also, based on federal guidelines, a bank under a regulatory enforcement order is often told to reduce its concentration of real estate related loans. As I noted before, this is problematic because many of the small businesses community banks have traditionally provided credit to are directly related to the real estate development and building sector. And because new capital is tough to come by for many banks and overall loan demand is down across all sectors, especially community banks, their only option is to shrink portfolios to get their ratios in line.

While I understand the concern with over-concentration in any one sector, it is extremely difficult to rapidly change that mix of loans in a troubled economy.

And because bank's lending limits are based on how much capital they have, declining capital levels translate into fewer loans, in general.

There is no question it is more difficult today for borrowers to obtain credit. The combination of the poor economy, actual losses, aggressive pressure by regulators to reserve for predicted loan losses, regulatory orders directed at troubled borrowers and reducing real estate concentrations while private capital is sitting on the sidelines all lead to a difficult credit market.

Let me be clear: we want to make good loans to help businesses and communities grow. That's what we do, and that's what makes our Main Street banks – many of which are basically small businesses themselves – profitable and healthy. Here's why it is difficult right now, and it is the root cause of frustration from borrowers as well as bankers. We have been told the following from all fronts: "Lend more and be as flexible as possible with workouts, but also apply the hard lessons learned related to underwriting." So, to lend more money right now requires a delicate balancing act.

Based on the increased regulatory scrutiny and the protracted economic malaise, it is harder and harder each day to determine what IS a good loan and what IS and WILL BE a viable business to lend to in this economy. That's especially acute here in Georgia where residential and commercial real estate has been a dominant driver of economic growth.

Conclusion

In conclusion, the real estate lending market in Georgia is under stress, with problems being more severe in some categories than others. Any loans for actual properties or business directly related to residential development or construction remain under severe stress. The multi-family real estate sector is also experiencing difficulty, with some long-term positive signs based on demographics. Retail-based real estate is a cause for considerable concern with unemployment remaining high and consumer spending under pressure. Owner-occupied real estate, while under pressure, is holding its own for now.

The overall success of TARP is mixed, with extremes depending on whether a bank was or was not a recipient.

Georgia's banks continue to struggle to raise new capital or retain capital that could be used to support new lending and stimulate the economy. The causes of the ongoing stress are the ongoing poor economy, certain regulatory policies and general uncertainty about the long-term structure of the banking sector.

Many of our banks need more capital. I understand that the Treasury Department has effectively closed the Capital Purchase Program and the Capital Assistance Program. Based on these factors, I encourage the I encourage your panel to recommend that policymakers examine new ways to make uncommitted TARP funds or repaid TARP funds available to more community banks in Georgia and across America. These investments could stabilize more communities and the banks that serve them, keep more banks open and free up more capital that could be deployed in support of new loans.

I also encourage you to evaluate the current regulatory structure to determine if shelf charters, loss-share agreements, mandatory suspensions of credit and large-scale bank closures are really the best ways to stabilize our industry and our nation.

Bipartisan cooperation between policymakers, regulators and bankers is the best way to get America's economy and financial system back on track. I certainly hope that we can move in that direction, and I sincerely appreciate your efforts to make that happen.